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Formal Credit Supplies for
Rural Enterprises

by

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Assessment Project

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FOREWORD*

This paper is one of a series produced by the Rural Off-Farm Employment Assessment Project at Kasetsart University. The Project is funded by the U.S. Mission of the Agency for International Development in Thailand under Project No. 493-0306. The objective of the Project is to provide information to the Royal Thai Government, USAID, and other international donors, to be used to identify and develop appropriate policies and programs for the rural non-farm sector in Thailand.

The Working Paper Series is designed to share interim or preliminary results on different aspects of the Project work. Some papers also discuss methodologies to be used in future studies.

A list of Working Papers produced to date, along with a list of Research Papers of the Project, is included at the end of this report. Copies of papers in either series can be obtained from Dr. Tongroj Onchan, Director, Center for Applied Economics Research, Kasetsart University, Bangkok 9, Thailand.

Tongroj Onchan
Project Director

ABSTRACT

This paper reviews recent developments in rural finance in Thailand. Formal credit supplies for farm enterprises have sharply expanded since 1975 due to government quotas for commercial bank lending. Rural nonfarm enterprises, however, have been largely ignored. Most lending to nonfarm enterprises by specialized agencies is concentrated in and around Bangkok with limited impact on agriculturally related activities. Some new credit programs are being considered which may eventually improve the credit supply situation. Little information is available on the nature of demand for borrowing. More study of the current credit supply situation and ways to improve it are required if the stated objective of assisting the small-scale sector is to be realized.

FORMAL CREDIT SUPPLIES FOR RURAL ENTERPRISES^{1/}

1. INTRODUCTION

Agricultural credit is a key policy instrument in Thailand used to accelerate and shape the pattern of rural development. Recent policies have sharply increased formal credit supplies in rural areas and have encouraged commercial banks to expand their capabilities to service rural needs. The impact of these developments has yet to be carefully analyzed.

1.2 One of the objectives of the Rural Off-Farm Employment Assessment Project is to evaluate the role of finance relative to employment in rural areas. Several research projects are being conducted to assess how finance may influence economic enterprises in rural industries and in farm households. An important question is the extent to which firms face credit constraints. That question is extremely complex to resolve definitively. Yet the answer is important for anyone who is interested in promoting increased credit supplies as a way to stimulate production and employment.

^{1/} This paper is a revision of a paper entitled "Formal credit for Farm and Non-Farm Enterprises in Rural Areas of Thailand" presented by the author at the Workshop on Rural Finance, Kathmandu, Nepal, April 7-9, 1980. I appreciate the comments received from Dale Adams, Bruce Bolnick, Dennis Conley, and Tongroj Onchan on that paper. I also appreciate the assistances of Saroj Aungsumalin in preparing that paper.

This paper reports on an analysis of the formal credit supply conditions of rural finance.^{2/} The first section reviews credit activities related largely to farm enterprises, while the second section discusses credit for nonfarm enterprises. The final section discusses some of the problems which appear to face rural enterprises in obtaining formal credit and additional research that should be conducted in order to more thoroughly understand rural finance issues.

II. FINANCING FARM ENTERPRISES^{3/}

The principal sources of formal institutional credit for farmers, processors, and distributors of agricultural products and inputs are commercial banks, cooperatives and the Bank for Agriculture and Agricultural Cooperatives (BAAC). Other government agencies make smaller amounts of credit available for special development projects. The Bank of Thailand (BOT) has been particularly active in recent years in regularizing and coordinating financial intermediaries, particularly commercial banks, and providing funds to lending institutions.

^{2/} It is generally believed that both farm and nonfarm rural enterprises use large amounts of informal credit. However, little information is currently available for use in discussing this source of credit.

^{3/} This section draws heavily from the paper by Meyer, Baker and Onchan. Additional details and analysis about farm finance are found in that paper.

The activities of the BOT became important for farmers beginning in 1967 when it was first authorized to rediscount promissory notes arising from agricultural transactions. Rediscount arrangements were eventually developed for notes issued for agricultural production, marketing, livestock production and purchasing of agricultural inputs. By 1978, rediscount operations had grown to over B2 billion^{4/} with BAAC accounting for about 90 percent of the total.

Prior to 1975, only 5 of the 29 commercial banks in Thailand did much farm lending. Response to the rediscounting mechanism was modest so the BOT adopted a quota system. By the end of 1975, the commercial banks were required to lend to agriculture at least 5 percent of their total 1974 lending. The quota could be met either through direct lending or through deposits with BAAC. Loans to agro-business, warehouses and fertilizer and machinery imports did not count toward meeting the quota. Each subsequent year, the quota was raised so that for 1979

^{4/} Twenty baht (B) have been approximately equal to one U.S. dollar for the past several years.

it was set at 13 percent of 1978 year-end deposits.^{5/} Of that 13 percent, two percent could be allocated to agro-business.

A third policy regarding agricultural lending was later established by the BOT. The previous controls over opening new bank branches were relaxed, but each new branch was required to lend at least 60 percent of its deposits in the local area and at least one-third of the loans must go to farmers. Banks not able to meet this requirement were required to deposit the remaining amount with the Bank of Thailand. A number of banks had difficulty meeting this condition so that as of November 30, 1978, such deposits amounted to 868.7 million (Bank of Thailand, Annual Economic Report, p. 134). The total number of branches at the end of 1979 had grown to 1,400, but about 60% were concentrated in the wealthier central region.

Finally, the BOT in its coordinating role works with banks to determine the amount of their quota that should be channelled to BAAC to regularize its source of funds. Several banks still do little farm lending and their entire quota is deposited with BAAC.

^{5/} The expected increase in quota to 15 percent for 1980 was postponed due to liquidity and administrative problems banks faced at the end of 1979 in making loans to agriculture.

The impact of BOT policies on commercial bank lending is clear. The number of banks with agricultural portfolios has grown from 5 to 16. Table 1 shows the growth of bank loans and overdrafts in recent years. From 1971 through 1974, the agricultural share of total lending actually declined slightly. Beginning in 1975, however, that share began to increase until it reached almost 5.5 percent by the end of 1979^{6/}

Another measure of commercial bank lending is seen in Table 2 where the yearly goal is given along with actual direct lending and BAAC deposits. The goal increased from B4.3 billion in 1975 to over B20 billion in 1979. In the same period, commercial bank direct agricultural lending rose from just over B2 billion to more than B17 billion. In most years, the banks surpassed their lending quota. In 1979 they lent a large amount to agro-business but failed to meet the quota for agriculture due to liquidity problems.

In terms of volume, the largest single source of agricultural credit is BAAC. It was formed in 1966 to take over the cooperative lending activities of the former Bank of Cooperatives and institute direct

^{6/} Two reservations need to be kept in mind regarding these data. First, some double counting exists because of inter-bank transfers. Second, some redefinitions of loans probably occurred as banks attempted to meet their quotas.

Table 1. Commercial Bank Loans and Overdrafts Outstanding^{a/}
Total and Agricultural, Thailand, 1971 to March, 1980
(Million Baht)

Year	End of Year Balance		Percent Agricultural
	Total	Agricultural ^{b/}	
1971	31,709.8	742.7	2.34
1972	35,845.7	771.2	2.15
1973	51,291.2	990.5	1.93
1974	68,815.7	1,305.3	1.90
1975	82,898.8	2,823.7	3.41
1976	96,377.3	4,121.4	4.28
1977	122,810.0	6,340.5	5.11
1978	160,878.5	8,656.9	5.38
1979	198,363.2	10,774.9	5.43
1980 (March)	199,387.4	9,827.8	4.93

a/ Including inter-bank transfers.

b/ Including agro-industries.

Source: Bank of Thailand, Monthly Bulletin, Vol. XX
No. 4 April, 1980.

Table 2. Year-end Balances of Agricultural Lending By Commercial Bank: Direct Loans and BAAC Deposits, Thailand, 1975-1979.
(Million Baht)

Year	Goal	Direct	Actual	Total
			BAAC Deposits	
1975	4,333.3	2,233.6	1,670.8	3,904.4
1976	6,139.0	3,810.9	3,160.6	6,971.5
1977	9,647.0	5,891.8	4,528.0	10,419.8
1978 Agriculture	11,771.0	8,099.5	5,511.4	13,610.9
Agrobusiness	2,616.0	6,382.5	-	6,382.5
Total	14,387.0	14,482.0	5,511.4	19,993.4
1979 Agriculture	17,322.4	9,970.0	6,330.1	16,300.1
Agrobusiness	3,149.6	7,755.8	-	7,755.8
Total	20,472.0	17,725.8	6,330.1	24,055.9

Source: Bank of Thailand unpublished statistics.

lending to farmers. The BAAC had 58 provincial branch offices, 409 field offices and over 780 thousand farmers registered as direct clients on March 31, 1979 (BAAC).

The financial structure of the BAAC can be seen in Table 3. About half of the liabilities are represented by commercial bank deposits. About twenty percent of the liabilities are deposits by private individuals and government agencies. Almost twenty percent represent rediscounting of notes with BOT. The BAAC has become more active recently in deposit mobilization from farmers, but previously it was heavily dependent on government support and commercial bank deposits.

BAAC makes two types of loans: loans to individual farmers, usually organized in informal groups, and loans to Farmers Associations and Cooperatives. Table 4 reports on the growth of loans in each category. The volume of loans made and outstanding grew slowly until 1974 when the growth rate sharply increased, in large part due to the commercial bank deposits. The total amount of BAAC credit outstanding at the end of 1979 was about P211 billion, a bit more than the commercial banks.

Table 3. BAAC Liabilities and Capital, March 31, 1979.

(Million Baht)

Item	Amount	Percent
Liabilities		
Deposits		
Public and Gov't agencies	2,167 ^{a/}	19.8
Commercial banks	5,586	51.0
Borrowings		
Domestic sources	327	3.0
International sources	627 ^{b/}	5.7
Notes payable to BOT	1,990 ^{c/}	18.2
Other liabilities	<u>255</u>	<u>2.3</u>
Total	10,952	100.0
Capital		
Paid-up capital		
Held by Ministry of Finance	1,403	79.1
Held by cooperatives and private individuals	17	1.0
Accumulated profit	296	16.7
Reserves	<u>57</u>	<u>3.2</u>
Total	1,773	100.0

^{a/} General time and saving deposits, and unmatured balances of loan compensatory deposits.

^{b/} Loans from U.S. and Japan.

^{c/} Rediscount operations with BOT.

Source: BAAC, Annual Report, 1978.

Table 4. BAAC Loans by Type of Borrower, Thailand, 1970-1979
(Million Baht)

Year	Loans to Individuals		Loans to Farmers Associations		Loans to Agricultural Cooperatives	
	Made	Outstanding	Made	Outstanding	Made	Outstanding
1970	563.3	753.7			198.1	409.2
1971	509.4	843.3			203.5	539.5
1972	670.9	993.8			276.7	681.5
1973	773.7	1101.2	3.4	3.4	307.0	785.3
1974	1203.7	1446.1	142.7	138.6	388.7	966.6
1975	2100.9	2472.8	387.8	440.9	866.1	1642.4
1976	3200.9	3848.9	288.2	533.0	914.7	2172.9
1977	3789.2	5012.0	267.4	589.6	1005.6	2679.0
1978 ^{a/}	4041.7	4403.9	263.9	521.0	1207.4	2536.1
1979 ^{b/}	4676.3	5679.7	183.4	481.8	1641.1	3008.1

^{a/} Jan. 1977 to March 31, 1978

^{b/} Fiscal year 1978, April 1, 1978 to March 31, 1979.

Source: BAAC Annual Reports and unpublished statistics.

One way to place agricultural credit in perspective is to compare growth of credit with growth of output. Although the data are somewhat incomplete, it appears that the ratio of formal agricultural credit to GNP was about 0.03 in 1973. The ratio increased to more than 0.13 by 1977. This increase suggests that farmers should have been able to finance a substantially larger proportion of their agricultural expenses with formal credit.^{7/}

There have been no large-scale credit surveys in recent years to show how many farmers have benefitted from this credit expansion. It appears that about 700,000 farmers currently borrow on an individual basis from BAAC in a year. Roughly the same number may borrow from cooperatives and farmer groups. No information exists on number of clients of commercial banks. It is generally believed that commercial banks serve larger farmers and make larger average size loans than BAAC. Assuming that some farmers receive more than one loan and some borrow from more than one source, it is possible that a total of 1.5 million Thai farmers may receive formal credit in any one year. The total number of farm households is about 5 million so perhaps 30 to 35 percent receive formal credit.

^{7/} The calculations and assumptions used in deriving these estimates are explained in detail in Meyer, Baker, and Onchan.

A number of problems obviously exist at this stage in the development of the agricultural credit system. Significant amounts of arrears are accumulating in BAAC. The costs of making and servicing loans is high and lenders complain about the impact of these costs on profits. Most credit goes for short-term purposes and, although important experiments are underway with group liability loans, a great deal of the lending is still based on collateral. The Bank of Thailand has noted that the expansion of formal credit has mainly benefitted middle income farmers and relatively wealthy farmers with loan collateral (Bank of Thailand, Annual Economic Report, p. 9). Nevertheless, these recent changes have increased the role of formal credit in shaping rural development.

III. FINANCING RURAL NONFARM ENTERPRISES

The previous section briefly summarized recent developments concerning credit for farm enterprises. This section analyzes the situation concerning nonfarm enterprises. Two types of enterprises are of interest to the Rural Off-Farm Employment Assessment Project. The first type refers to enterprises found in nonfarm firms in rural towns and villages. These include processing enterprises for sugar cane, cassava, kenaf, fruits and vegetables; silk and cotton weaving; woodcarving; ready made garments; pottery

and ceramics; etc. Many of these enterprises are closely tied to farming because they use farm produced raw materials, use farm labor and are highly dependent on farm household demand. The second type includes nonfarm enterprises of farm households. This category covers such diverse enterprises as silk weaving, pottery making, mat making, making baskets and other bamboo products and blacksmithing. These enterprises may be either the primary or secondary source of income for the households.

Thailand is beginning to recognize the importance of these enterprises and the Fourth Five-Year Plan placed increased emphasis on them (Government of Thailand.) However, there is little information on the nature, extent and composition of these enterprises or their problems. Tambunlertchai discussed the results of one of the few studies conducted on small-scale industries. This study was based on a nationwide sample of more than 1,000 small-scale manufacturing firms employing from 10 to 200 workers. The results showed the expected pattern of a large number of labor-intensive small firms with fewer more capital-intensive large ones. Like similar studies in other countries, the study concluded that small firms faced financial problems, were mostly self-financed and depend much more on informal credit in both the initial and operating stages of production. They have poor accounting and lack collateral so they frequently turn to informal credit sources.

These sources usually charge higher interest rates so it is assumed that small firms face credit constraints from formal supplies.

Although the argument is appealing, in reality it is very difficult to determine the extent to which inadequate formal credit is an important constraint for small-scale firms.^{8/} Considering the present situation in Thailand, however, the credit constraint argument is plausible.

3.1 Sources of Formal Credit.

Only fragmentary information is available on the amount of formal credit going to nonfarm enterprises. Commercial banks, BAAC, the Industrial Finance Corporation of Thailand (IFCT) and the Small Industries Finance Corporation (SIFO) are the most important potential sources of formal credit. Other governmental agencies have various types of rural development programs which include small finance components. Commercial banks and BAAC should be the most important sources since they have the most resources and only they have a nationwide network of branches. Unfortunately, it is impossible to use published data to analyze bank credit to nonfarm enterprises because it is reported only as overdrafts. Apparently much of the credit used by processors of rice and cassava for purchasing supplies is obtained by overdrafts. It is unlikely that many small nonfarm firms receive

^{8/} See Meyer for a more detailed discussion of the problem of clearly establishing the existence of external credit constraints.

much credit this way, however, since overdraft provisions require a deposit account and normally are fully collateralized. Until recently, few attempts were made to develop special loan programs for nonfarm firms. Likewise, with the exception of a few small special projects, BAAC has put little emphasis on nonfarm enterprises. Since many farm households have both farm and nonfarm enterprises, however, it is likely that some funds borrowed from banks and BAAC, supposedly for farm enterprises, have been diverted to nonfarm enterprises, with or without the knowledge and consent of the lender.

3.2 Industrial Finance Corporation of Thailand (IFCT).

The privately owned IFCT is an important potential credit source. It was incorporated in 1959 as a development bank to "offer financing facilities which are more attractive in terms and conditions than those which are generally available from other financial institutions within the country, so as to encourage increasing industrial activities in Thailand's private sector" (IFCT, 1972 p.2). The government has assisted IFCT with low interest loans, guaranteed loans obtained in Thailand and abroad, and exemptions for taxes on income and profits. In 1980, about 70 percent of its funds were from foreign sources. IFCT makes direct medium and long-term loans, both in local and foreign currencies, to establish, expand and modernize industry and

participates with commercial banks in large scale projects. Beginning in 1978, IFCT began to make working capital loans to its clients. It also makes equity investments in certain projects.

During the 1970's, IFCT made 40 to 50 loans per year (IFCT, 1980). In 1979 it approved 54 loans for just over B1.1 billion, and 21 loans for B450 million in the first half of 1980. From 1960 until June 30, 1980, 541 loans were approved for B6.6 billion. As of June 30, 1980, B3.1 billion in loans were outstanding. Manufacturing broadly defined represented about two-thirds of the value of loans outstanding, and cement was the largest single industry with just three loans representing 15 percent of total loans outstanding. The second major general group was agri-business and food processing with 67 loans representing 17 percent of loans outstanding. This category included loans for the production and processing of fruit, vegetables, livestock, poultry and eggs, edible oils, sugar, noodles, fishmeal and other fish products and cassava flour, pellets and chips.

Although the total agricultural impact of IFCT lending is important, the impact on small-scale agricultural or rural industries is not for two reasons. First, some progress has been made to broaden the geographic distribution of loans but in most years about 50 percent of the loan value has been lent for projects in the Greater Bangkok area and another 35 to 40 percent in the Central region.

Second, the average loan size has been quite large in keeping with the concept of most development banks. Information on the total loan portfolio categorized by size of loan is not available, but unpublished data reports total investment costs of projects supported by IFCT. Small-scale projects are defined as those with less than \$5 million per project. From 1974 through 1979, about 10 percent of the projects financed fell in the small-scale category but these projects represented less than one-half of one percent of the total investment costs of all projects.

3.3 Small Industries Finance Office (SIFO).

SIFO is the only government agency specifically in the finance of small industries. It was created in 1964 to provide financial and management services to small industries and power generating facilities. Its financial structure permits it to make only about \$200 million in total credits. Loans can be made for a maximum of 10 years for purchasing machinery and equipment, acquiring land for plant sites, erecting buildings, and for working capital. The maximum size of loan is \$1 million per client.

Currently SIFO has less than 1,000 loans outstanding with a total value of \$130 million.^{9/} By 1978 after 15 years of operation, only 1,109 loans had been made for just over \$352 million. Recall that IFCT made over \$1 billion in loans in 1979 alone! The

^{9/} Data for SIFO were obtained from the 1975 annual report and subsequent mimeographed statistical summaries.

most loans made by SIFO in any one year, 119, were made in 1969 when they lent 32 million. The largest amount of money lent in any year was in 1977 when 46 million were lent. Almost 95 percent of the total loans were for 6 years or less. Furthermore, not all loans are completely disbursed in the year made. The maximum amount of loans outstanding never reached more than 75 million between 1964 and 1974.

The most recent detailed breakdown of industries receiving SIFO loans covers loan commitments through 1975 (Table 5). Metal working industries represent the largest single beneficiary, closely followed by construction materials. The distribution of industries gives the impression that a surprisingly large number of the firms benefited are urban oriented. The geographic distribution of loans made supports this impression.

The geographic distribution of 997 loans made from 1964 to 1977 and 85 loans made in 1978 was analyzed. About 28 percent of the loans with 32 percent of the volume went to Greater Bangkok from 1964 to 1977. An additional 16 percent of the loans with almost 20 percent of the volume went to the other provinces of the Central region. Thus, over half of the loans went to the richest region of the country, while the poorest Northeast region with the most serious employment problems received only 15 percent of the loan volume. The situation was even worse in 1978 when the Central

Table 5. SIFO Loan Commitments by Industry, Thailand 1964-1975.
(Thousand Baht)

Industry	No. of Loans	Amount of Loans
I. Metal working		
a. Metal products	61	22,041
b. Machinery	28	9,281
c. Servicing	95	23,403
d. Handicraft	17	2,637
II. Consturction materials	164	42,770
III. Textile	95	31,111
IV. Leather industry	14	3,944
V. Ceramic	20	6,140
VI. Food	86	26,425
VII. Animal feed	72	21,608
VIII. Chemical	11	2,162
IX. Handicraft	47	9,060
X. Rubber products	23	9,372
XI. Wood products	13	3,035
XII. Plastic products	15	4,490
XIII. Boat and bus body building	18	7,019
XIV. Miscellaneous	<u>38</u>	<u>11,492</u>
Total	818	235,990

Source: Small Industries Finance Office (SIFO),
Annual Report, 1975.

region received almost 70 percent of the loan volume compared to only 3 percent for the Northeast. This regional shift seems to have become more accentuated in recent years. For example, an analysis of the loans made in 1975 showed that about 40 percent of the volume to Greater Bangkok. Thus, it appears that the only significant governmental finance agency for small industries has been insignificant in terms of loan volume. Furthermore, it has not significantly assisted agriculturally related enterprises, nor has it materially contributed to reducing industrial concentration in Greater Bangkok.

334 New Initiatives

Total institutional lending to nonfarm enterprises and rural business is very modest compared to the major expansion in farm credit in recent years. A few changes are occurring, however, which may eventually increase formal credit supplies.

IFCT is currently negotiating with the Japanese government for a U.S. \$20 million long-term loan which would help streamline its procedures, increase its network of officers and supply more working capital as well as fixed capital to its borrowers. These changes should improve its ability to lend to small, up-country projects.

The Siam Commercial Bank, one of the larger commercial banks, is negotiating with the Industrial Finance Corporation of the U.S. for a U.S. \$2 million loan for an experimental project to fund small and medium businesses. The Bank will provide an equal amount

to make a total fund of 840 million. Loans will be made to businesses that have 83 to 10 million in total fixed assets and working capital. The IFC funds will be lent for acquisition of long term assets, while the local currency funds will finance working capital. The combined interest rate will likely be 1 to 2 percent below current commercial rates. Advisory services will also be provided to the borrowers.

Finally, the Cabinet recently gave approval to a proposal to convert SIFO into a finance corporation. This would permit it to acquire loan funds from commercial sources and international lenders and thereby expand its activities. This proposal has been debated for a long time and the reorganization of SIFO was even called for in the Fourth Development Plan covering the period 1977-1981.

3.5 Impediments to Increased Lending

Admittedly, the data reported above are sketchy but the impression clearly emerges that a new dynamism has been introduced in formal credit for farm enterprises but credit for rural nonfarm enterprises has been largely ignored. What explains this difference? Why has BAAC, a government agency, been given massive support, while SIFO, another government agency, has languished?

Much of the explanation for the emphasis on farm credit can be linked to the perceived problems of the rural sector. Historically Thailand's agricultural credit policy was heavily influenced by the belief that farmers are victims of money lenders (Onchan). It was believed that unless farmers had access to formal credit they would borrow from informal sources at exorbitant interest rates and lose their farms when they failed to repay. More recently the emphasis has been on using credit as a means to stimulate farm production and technological change, both of which are necessary if satisfactory growth in exports and stable food prices are to be achieved. The implications of not meeting the exploitation and growth issues are serious and evident. This has contributed to support for policies to expand BAAC and to encourage bank lending to farmers.

The lack of support for nonfarm credit is puzzling. Perhaps it has been felt that traditional commercial sources were satisfactory and the borrowers were able to pay the on-going rates. Perhaps policy makers have felt that industrial performance was adequate and little attention was needed for the smaller and weaker firms in the sector.

One important factor seems to affect the performance of both the private and public sector in lending to the nonfarm sector. That factor is interest rate controls. For many years, Thailand has had a usury law which governs the interest rate that institutions can

pay on savings and charge for loans. Until January, 1980 the maximum lending rate on many categories of loans was 15 percent. BAAC has been limited to 12 percent on loans to farmers. IFCT has operated on a policy of a fixed mark-up of 2.7 percent over the cost of funds lent. Likewise, some categories of deposit rates are fixed but have been allowed to increase over time, while the lending rate remained constant. Faced with rising costs and the same interest rate for small and large loans alike, it is not surprising that lenders have concentrated their portfolios in large loans located close to Bangkok where servicing costs could be minimized.

The case of SIFO with respect to interest rates and costs of operation is particularly interesting and clearly demonstrates the problem faced by lenders. SIFO was set up as a joint venture with the partially government owned Krung Thai Bank. The Bank appraises the security offered as collateral for a loan, while SIFO conducts the technical and economic assessment of the application. A Loan Board composed of the General Manager of the Krung Thai Bank, the Managing Director of SIFO, and representatives of several government offices makes the final decision on the application.

A special joint loan fund was developed on a one to three formula, that is the government provided about B50 million for

SIFO's contribution, while the Bank provided a little over B150 million for a total fund of just over B200 million. SIFO earns 3 percent interest on its funds deposited with the Bank and the Bank earns 9.5 percent interest on the total amount lent to borrowers. The 9.5 percent maximum rate was set to aid small businesses that supposedly could not pay the higher rates charged by commercial lenders.

This arrangement created an unusual set of disincentives for both SIFO and the Bank. First, SIFO earns a fixed income of 3 percent on approximately B50 million, or B1,500,000. With this amount it must meet the rising costs of appraising loans in an inflating economy. It is forced, therefore, to reduce expenses by curtailing travel out of the Bangkok area and by increasing the average size of loans made. Thus SIFO's portfolio has become increasingly concentrated in loans made in or near Bangkok, and it cannot be aggressive in seeking new customers elsewhere.

On the other hand, as a commercial bank, the Krung Thai Bank has alternative uses for its funds. It could charge the maximum 15 percent rate set for other types of loans. The Bank is evaluated with several standard banking performance measures even though it is government owned so the officers are logically concerned about costs and income. The Bank has three options when evaluating a loan recommended by SIFO: make the loan using the special

SIFO/Bank fund, make the loan directly with its own funds or refuse to make the loan.

Consider the example of a loan for $\text{N}1$ million, the maximum currently allowed under the program. Under the first alternative, $\text{N}250,000$ would be drawn from SIFO funds and the balance from the Bank. The Bank would earn 9.5 percent interest or $\text{N}95,000$ per year. Assume further the average cost of the Bank's resources is 6 percent.^{10/} Thus apart from the costs of appraising the collateral, the Bank's costs are $\text{N}45,000$ ($\text{N}750,000 \times 0.06$) so the annual net return is $\text{N}50,000$. Suppose, however, the application is sound enough so the Bank makes a direct loan at the maximum 15 percent rate. Then its income is $\text{N}150,000$ and the costs are $\text{N}60,000$ for a net income of $\text{N}90,000$. In the first case, the rate of return on $\text{N}750,000$ invested is 6.7 percent, while in the second case the return is 9 percent on $\text{N}1$ million. Of course, in the second case the Bank must analyze the application and suffers the entire loss if there is one. But the example shows why, as it is alleged, the Bank would choose to make direct loans to some applicants after SIFO has done the analysis.^{11/} It also suggests why the Bank would be reluctant to lend all funds committed to this program when it has alternative uses earning a higher rate of return.

^{10/} Based on the structure of deposits at the time, it was estimated that the weighted average cost of commercial bank deposits in 1978 was 5.5 percent (Meyer, Baker and Onchan, P.37).

^{11/} In a sense an analysis of the benefits of SIFO should include the fact that perhaps some borrowers get these direct loans because of SIFO's analysis.

The issue of SIFO/Bank interest rates reached a crisis in 1980. It was reported that the Bank argued for a higher lending rate which SIFO felt was inconsistent with the concept of helping small businesses. Simultaneously, SIFO demanded a higher rate paid on its deposits with the Bank. No loans have been made by SIFO for several months. This resulted in the strange paradox that through SIFO's efforts to help small business by keeping the interest rate down it caused them to get no credit at all.

The SIFO program represents another example of the fallacy of concessionary interest rates so popular in many credit programs. The objective of a concessionary interest rate (i.e. rate lower than prevailing for other loans) is to help a sector considered worthy of such assistance. Yet the peculiar SIFO-Krung Thai Bank arrangement, with the disincentives inherent in the low interest rate, restricts the expansion of loans to a broader clientele. Furthermore, complicated and time consuming lending procedures raise borrower costs so they are substantially higher than the concessionary interest rate. Clearly the intended beneficiaries are not well served by this arrangement.

Fortunately some flexibility seems to be developing in interest rates. The increase from 15 to 18 percent in the maximum rate on several types of commercial loans which occurred in January, 1980,

was a major achievement. In October the IFCT announced a one-half percent increase in the rate charged for agro-industry and rural industry loans to bring the returns more in line with costs. Hopefully, the idea that low interest rates are a major impediment to lending to nonfarm enterprises will become increasingly recognized and lenders will be permitted to set more flexible and realistic rates.

IV. RESEARCH NEEDS ON RURAL FINANCE

Information on rural finance in Thailand is sketchy. The situation is relatively better for farm finance but even in this area the information available is either out dated or limited in geographic coverage. Resources for research have not kept pace with the expansion in lending.

A relevant question concerning farm finance is the impact of the recent expansion in formal credit. Which farmers have received it, where and for what purpose? Has it financed new investment or simply substituted for informal sources? Do profitable farm investments still exist for current borrowers or have they already adopted the most profitable ones? How about non-borrowers? Do farmers have profitable opportunities for nonfarm enterprises that should be financed? Some attention will be given to these issues by the Project staff, but many fall outside of the scope and resources

available to the Project.

Information on demand for formal credit for nonfarm firms is even more urgently needed. Many observers believe that finance is a constraint and this fact justifies efforts to expand formal credit supplies. That opinion seems to be based, however, on a rather uncritical interpretation of entrepreneurs responses to questions about their problems. It is likely, in fact, that many problems of firms manifest themselves in financial ways. For example, if a firm has poor inventory control and maintains excessive input supplies, it will require larger than normal working capital to finance the inputs.^{12/} Considering the little attention given to finance and the small amount of formal credit apparently going to small-scale firms, it is possible that some firms face real financial problems, not technical or management problems in disguise. The problem is to identify which industries and firms face credit constraints and how credit programs should be designed to meet their needs. This will be the subject of the research of one of the Project staff with special emphasis on cement product firms.

^{12/} Harper found a serious problem facing small shopkeepers in Kenya was their poor inventory management. Better management would have released funds for expanding the business, while the businesses reported that finance was one of their serious problems.

A large number of questions exist about the supply of rural finance and problems of financial institutions in meeting rural finance needs. A key issue will likely be the repayment performance of borrowers and its impact on lenders as the large amount of loans made in recent years become due. The impact of the farm loan quota on income and profits of lenders is an open question and will continue to be raised whenever the possibility of raising the quota is discussed.

A problem in conducting research on supply issues is that lenders are sensitive about divulging confidential information. However, two studies related to credit supplies are being planned by the Project. The first concerns lender behavior regarding lending to small nonfarm firms and nonfarm enterprises in farm households. There is little information available in Thailand on important economic issues such as returns, costs and risks of lending to small nonfarm firms compared to large firms or compared to farm lending.^{13/} Nor is there any information on lender perceptions of such issues. Yet these factors undoubtedly affect the amount lent to various economic activities. An attempt will be made to identify policies or programs which might be used to encourage lenders to increase their nonfarm portfolio.

^{13/} A study by Saito and Villanueva of the Philippines experience is an interesting example of the type of analysis that could be useful.

Second, an attempt will be made to study the experience of SIFO borrowers. Although the portfolio is small, the SIFO program is the only one in Thailand of any size with which to analyze the impact of credit on small firms. It is quite likely that the SIFO borrowers will represent a wide range of business successes and failures. Thus, they represent a valuable sample for the study of problems of small firms and the impact of credit and technical assistance. Also such a study can provide insights into the problems of lending to such firms.

These research activities of the Project in the area of rural finance will only make a small contribution towards the vast amount of information required to develop rural financial markets in Thailand. But it is hoped they will identify some key issues that require additional research as well as potential new lines of credit to meet needs that are identified.

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